



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PPD 730.5.17

27 April 2000  
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MEMORANDUM FOR REGIONAL DIRECTORS, DCAA  
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Performance of Financial Capability Risk Assessments

Background

The current audit guidance (CAM 14-303) advises that financial capability risk assessments are normally updated on an annual basis at major and non-major contractors where other field visits are made during the year. However, at non-major contractors where annual field visits might not be made, the assessment should be made in connection with the next regularly scheduled audit.

At the September 1999 Executive Steering Committee (ESC) meeting, one of the presentations focused on the frequency of the performance of financial capability risk assessments and the possibility of not consistently following the aforementioned guidance. The low number of requests from field audit offices (FAOs) for financial data from the Technical Support Branch (OTST) compared to the number of active contractors gave the impression that financial capability risk assessments were not routinely performed. Therefore, each of the regions and the field detachment were requested to survey their FAOs to determine the frequency of the performance of financial capability risk assessments. The results of their self-assessments were received by Headquarters in January and presented at the March 2000 ESC meeting. Overall, the general consensus was that a majority of FAOs were not performing financial capability risk assessments for major or non-major contractors as required by CAM 14-303. If risk assessments were performed, they were more frequently performed at major contractors rather than at non-major contractors. As a result of those findings, the following revised audit guidance was approved at the March 2000 ESC meeting to address the frequency of the performance of financial capability risk assessments.

Guidance

In order to obtain a baseline in assessing the financial status of the contractors within our audit cognizance, a detailed financial capability risk assessment should be performed within one year of this implementing guidance at those contractors where we have visited the contractor's location during the year. If a detailed financial capability risk assessment is not performed within the one year time period due to audit inactivity at the contractor's location, a detailed financial capability risk assessment will be performed at the first field visit during the subsequent year. However, if a detailed financial capability risk assessment was performed in the year prior to this implementing audit guidance and no indicators of financial distress were found, then a modified financial capability risk assessment may be performed in the current year as indicated in *Scenario 2* below. A detailed risk assessment consists of performing the risk assessment audit steps contained in CAM 14-304. This includes (i) calculation and analysis of the trend of the contractor's key financial ratios and a comparison to average industry ratios, (ii) calculation of the failure prediction model, (iii) evaluating financial statement statistics for indicators of financial distress, (iv) consideration of the adequacy of the contractor's internal control structure relating to

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financial planning and monitoring, and (v) consideration of other indicators that raise questions about financial distress.

If no indicators of financial distress are found in the first year, a modified financial capability risk assessment is performed in the second and third years after the implementation of this guidance. A modified risk assessment consists of the calculation and analysis of the trend of the contractor's key financial ratios shown in CAM 14-304c(3) and an analysis of any significant events of which the auditors become aware that would impact the contractor's financial status. The fourth and following years would repeat the pattern of the prior three years in the frequency of performing a detailed versus a modified financial capability risk assessment.

The following scenarios are provided to assist in determining if a detailed or a modified financial capability risk assessment should be performed in the current year:

*Scenario 1 - No detailed financial capability risk assessment performed in prior year.*

➤ Perform detailed financial capability risk assessment.

*Scenario 2 - A detailed financial capability risk assessment was performed in the prior year with no financial distress found.*

➤ Perform a modified financial capability risk assessment.

*Scenario 3 - A financial capability audit was performed in the prior year with no financial distress found.*

➤ Perform a modified financial capability risk assessment.

*Scenario 4 - A financial capability audit was performed in the prior year and financial distress was found.*

➤ Follow-up by performing a financial capability audit in current year.

#### Concluding Remarks

If FAO personnel have any questions regarding this memorandum, they should contact their regional personnel. If regional personnel have any questions, they may contact Jeff Miller, Program Manager; Policy Programs Division, at (703) 767-2270 or e-mail dcaa-ppd@dcaa.mil.

/SIGNED/ Robert DiMucci

(for)

Lawrence P. Uhlfelder

Assistant Director

Policy and Plans

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